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SUBJECT: BRAZIL: PUBLIC BANKS' RISING INFLUENCE BRINGS INCREASED  
RISKS TO FINANCIAL SECTOR

REF: (A) SAO PAULO 531; (B)SAO PAULO 320; (C) BRASILIA 950

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

11. (SBU) SUMMARY: Public bank growth in Brazil has played a positive counter-cyclical role against the impact of the global financial crisis, but has also raised concerns. In the near-term, continued growth in public bank lending could accelerate inflation. Over the longer term, public banks may begin to crowd out private lending. As Brazil's lending market matures, crowding out effects could intensify and impose larger efficiency costs on Brazil's financial system. Despite these risks, attempts to downsize the public banking sector, given the recognition it has received for bolstering the Brazilian economy through the crisis, will be politically difficult.  
END SUMMARY.

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Lower Rates & Increased Lending Bolster Economy  
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12. (SBU) Large public banks such as Brazil's Development Bank (BNDES), Banco do Brasil, and Caixa Economica have helped stabilize Brazil's economy in recent months by boosting credit flows and serving as a quasi-lender of last resort for the hardest-hit industries. The substantial increase in public bank lending is a result of significant pressure applied by President Lula at the outset of the global financial crisis in late 2008. BNDES lending rose sharply for capital goods purchases, SMEs, and trade finance, while Banco do Brasil boosted agricultural lending and Caixa Economica supported Brazil's housing sector. The GoB also instructed public banks to reduce loan rates. Rates on working capital loans, among the most important loan categories, for example are 5 to 10 percentage points below private bank rates. Banco do Brazil for example charges about 17 percent compared to Bradesco's 23 percent, according to the Central Bank.

13. (SBU) Increased lending by Brazil's public banks provided a key source of monetary stimulus, arguably even more important than the Central Bank's reductions in its benchmark Selic rate since bank lending injected credit directly into the economy rather than indirectly via price signals. Over the past year, total credit expanded nearly 20 percent while BNDES lending alone rose almost 40 percent.

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Advantages Over Private Banks Fuel Growth  
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14. (SBU) Public banks' in Brazil enjoy several market advantages over private banks. First, a significant portion of the public banks' funding comes from payroll taxation (FAT), which provides a low cost and captive source of funds. While estimates vary, the cost advantage that FAT funding provides is substantial. Private bankers have told Treasury's financial attache that they simply cannot compete for longer-run funding against the large public banks. Public banks also have access to additional funding directly from Brazil's Finance Ministry. Last December, for example, BNDES obtained a \$55 billion loan at a time when private inter-bank markets were completely frozen. The funding source provides public banks stronger implicit deposit guarantees than private banks. Finally, some of the liability advantages that public banks have allow them to take greater risk with their loan portfolios and other assets. For example, Banco do Brasil and Caixa Economica lend disproportionately to Brazil's highest-risk sectors and BNDES is Brazil's second-largest holder of equities -- a large degree of asset risk that private banks are less able to absorb.

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Rising Inflationary Risks  
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15. (SBU) As the economy recovers, continued growth in public bank credit could generate short-term inflationary problems, as private credit is likely to rebound. In a worst-case scenario, 2010 inflation could approach the central bank's 6.5 percent upper boundary target, a large but not catastrophic jump from the current 4.5 percent level. Adding to potential inflation risk, leadership succession at Brazil's Central Bank remains uncertain following Central Bank president Henrique Meirelles' expected resignation in

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the near future. Additionally, according to a contact from a major private bank, Mario Mesquita and Mario Toros, respected members of the Bank's interest rate committee (COPOM) are likely to step down later this year, although neither has publicly admitted this information. Fiscal policy is likely to remain expansionary over the next year as President Lula seeks to support his Chief of Staff, Dilma Rousseff's, presidential bid.

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Crowding Out Private Lending  
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16. (SBU) Since Brazil's current credit ratio is only 50 percent of GDP, all banks, including private banks, are likely to continue growing their loan books rapidly and remain highly profitable over the near-term. Sustained increases in public bank lending over the long-term could, however, eventually crowd out private lenders and become a structural drag on future bank competition. As crowding out effects rise, the subsidy and guarantee advantages that public banks receive could increase distortions and impose larger efficiency costs on Brazil's financial system and private sector customers.

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COMMENT  
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17. (SBU) As Brazil's economy recovers, lending will continue to grow. Public banks are eager to expand and many borrowers support public bank lending because the rates they pay are effectively subsidized by Brazilian taxpayers. Many Brazilians, including President Lula, credit Brazil's stable, if inefficient, banking system for helping Brazil successfully withstand the global downturn. President Lula has actually suggested publicly that a key weakness in the U.S. financial system is its absence of large public banks. This popularity makes any reform of the public banking sector politically difficult. Nevertheless, the growth of public bank lending does pose limited, but important, costs on the country that will rise in coming years as Brazil's loan market saturates. At that point restraining Brazil's public banks may be even more difficult. End Comment.

18. (U) This cable has been coordinated with Sao Paulo Treasury

Attache.